NEW CASTLE COUNTY TRANSITION 2017

FINANCE TEAM FINAL TRANSITION REPORT
PRESENTED TO COUNTY EXECUTIVE MATT MEYER
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Executive Summary

New Castle County's financial picture includes strengths and opportunities, as well as weaknesses, challenges, and threats. Strengths include a Triple A bond rating, award-winning financial presentations, a wealth of information available on line, a stable property tax base, a high rate of collections, clean audits, and a well-established budget process that includes NCCFAC and County Council.

The most glaring weakness is that the County's two major operating budget funds, the General Fund and Sewer Fund, currently face structural deficits that, in our opinion, cannot be eliminated via expenditure cuts alone. The County has significant unfunded pension and OPEB liabilities, although it is in better shape than most other governments in this regard. Budget deficits are more urgent, but in the long run, pension and OPEB funding are more serious. The County's legacy financial systems are past their prime. Speculative investments in start-up businesses are problematic, and should be avoided in the future.

County investment policy – or lack thereof – has likely cost the County approximately $10 million during the past four years. New investment advisors and regular reporting to Council are welcome developments, but not substitutes for an independent body of experts to supervise investments, modeled after the State's Cash Management Policy Board. Finally, reassessing property values for the first time since 1983 has both positives and negatives.

The single best opportunity for the new administration is a thorough review of the Assessment Office. Consideration should also be given to a public safety fee and/or PILOTs as revenue measures.

On the expenditure side, we suggest a fine-tooth comb review of spending, including but not limited to small consultant contracts, vacant positions, shared services with other jurisdictions, workers' compensation costs, and retiree health care. We also recommend a one-time special audit of County finances.

Finally, the County faces a number of threats. By far the greatest threat to the County's finances is State legislation that may be enacted in an attempt to ameliorate the State's own financial difficulties. Previous State proposals have already been revived that would reduce County revenue, require additional County spending, or both. However, this threat also provides an opportunity for negotiations, if those negotiations are conducted quickly but carefully.

The closure and downsizing of businesses and liberal State laws governing municipal annexations put the County's revenue base at risk. Significant federal funding is also in jeopardy given the stated positions of current federal officials. Finally, forthcoming GASB guidelines will increase pension and OPEB pressures.

Strengths

A close examination of New Castle County's financial picture reveals a number of weaknesses and threats, and presents a number of challenges, which will be discussed in later sections of this report. Nevertheless, it would be a mistake to characterize the County as in dire straits. In fact, the County's finances have a number of strong points, which include but are not limited to the following.

1. A wealth of information is readily available, starting with the two most important documents, the Comprehensive Annual Budget Summary (CABS) and the Comprehensive Annual Financial Report (CAFR).

2. Most (although not all) financial documents are available on line, a welcome degree of transparency. As a result, the Transition Team was able to prepare the bulk of this report by examining publicly available documents.

3. The County's Finance Department has made award winning accounting/budget presentations for more than 35 consecutive years.

4. All three bond rating agencies grade New Castle County as Triple A. The County is one of less than 1% of all counties in the nation (fewer than 40) who are similarly situated. Having said this, the Transition Team wishes to emphasize that constant vigilance is required to maintain the Triple A rating.

5. The County's property tax base is stable.

6. Property tax collections are at 99% of collectables annually, and have been for some time.

7. Recent outside audits have produced clean findings, without material weaknesses.

8. The County's Capital Improvement Program (CIP) appears confined to appropriate projects; no white elephants are discernible. Here again, we note that this situation could change rapidly if all capital projects are not subject to close scrutiny, due to their impact on both future operating costs and debt service payments.

9. County Council's budget review process is well-established and thorough.

10. The New Castle County Financial Advisory Committee (NCCFAC) has an equally well-established process to forecast revenues and expenditures.

Weaknesses

Along with its strengths, County finances also exhibit some weaknesses.

1. The most readily apparent weakness is that the County's General Fund revenue structure is non-diversified; 80% derives from a single sector of the economy, real estate. A significant component, the Realty Transfer Tax (RTT) is highly elastic. Previous County administrations have attempted to broaden the County's revenue structure, without success. Given current political constraints, the lack of diversity in the revenue structure is likely to remain a defining characteristic.

2. It is also clear that both the County's General Fund and its Sewer Fund are currently facing structural deficits.

In reaching this conclusion, we are using the layman's definition of structural deficit as a deficit not caused by an economic downturn and one that will not be eliminated by economic improvement. The County's on-line checkbook forecasts that both funds will need to draw from reserves over each of the next four years to achieve balance — and, if forced to do so, will reduce those reserves below appropriate levels. The County's sewer services are already priced below cost, having drawn from reserves in five of the past six years.

Due to its very high percentage of fixed costs, elimination of the Sewer Fund's structural deficit will almost certainly require action on the revenue side — in other words, a rate increase. Eliminating the General Fund's structural deficit, in contrast, may involve a mixture of spending reductions and revenue increases.

3. Pension funding was at 74.9% as of January, 2016. (A new valuation should be available within the next 60 days.) While this figure is better than that of many other governments, it should be noted that the funding percentage has declined over the past four years. In fact, funding declined by $27 million (6.3%) over the past year. The decline compares unfavorably with two jurisdictions familiar to the Transition Team, the State of Delaware and the Delaware River & Bay Authority, which posted declines in the 1% range. The County should give strong consideration to examining the current pension fund escalators, which are 3% compounded annually for FOP retirees and 2% (not compounded) annually for non-FOP retirees – regularly exceeding the rate of inflation. This situation will only worsen underfunding issues going forward.

4. Other Post-Employment Benefits (OPEB) present a similar challenge.

OPEB funding is currently 15.5%. While this percentage compares favorably to the 10.0% average of other governments, the County still faces a $194.5 million unfunded liability that is growing. The County has not been making its full Annual Required Contribution (ARC), and can be said to have been complying with the letter but not the spirit of Government Accounting Standards Board (GASB) guidelines. In doing so, it is not atypical of governmental bodies.

The General Fund and Sewer Fund structural deficits present a more immediate problem for the Administration, but pension and OPEB funding are the more serious challenges over the long term.

5. We note that the CIP is slated for a large increase in Fiscal Year 2018, due primarily to additional sewer construction. This increase should be scrutinized.

6. The County's legacy financial information technology systems are past their prime, and thus, present a risk of either deteriorating performance or considerable cost to upgrade/replace them.

7. Speculative investments in start-up businesses – the prime example being the $3 million loan to the promised Wilmington Stock Exchange – are problematic, especially when done without considerable risk sharing and a long-term strategic focus. We recommend that the County make no such future investments.

8. A significant portion of outstanding receivables due to the County should be reviewed with an idea of writing off those that are uncollectable.

9. Current County investment policy – or lack thereof – has likely cost the County significant money over the past four years.

The County's operating cash is partially in the hands of UBS ($93 million) and partially in the hands of Wilmington Trust ($45 million). UBS was instructed not to actively invest the funds in its care for four years. As a result, its rate of return was 3% lower than that of Wilmington Trust. The lower UBS rate of return suggests that the County missed out on approximately $10 million in income over those four years, money that obviously cannot be recouped. We understand that Council has been advised by UBS that an investment structure is now in place, with five designated sub-investment advisors, who will report on performance to Council quarterly.

While these developments are welcome, the Transition Team strongly recommends that a formalized independent body of experts be established to oversee these investments, similar to, for example, the State's Cash Management Policy Board. We understand that an ordinance to this effect was passed by County Council but vetoed by the previous administration, and that a similar ordinance is currently tabled. We recommend that it be reviewed by the new administration.

We further recommend that the terms and length of all investment contracts be reviewed and that management performance, past as well as potential, be examined carefully and objectively. Current performance, even if adequate, should be evaluated in light of previous, apparently unsatisfactory, results. Any future requests for proposals that are issued in this area should include the participation of subject matter experts in the selection process.

10. We conclude this section by noting that a County-wide reassessment of property values has not occurred since 1983. This 34-year gap makes the County vulnerable to a taxpayer equal protection lawsuit, similar to the one that succeeded in the 1960s. Rather than making a recommendation, we wish to present both the major negatives and the major positives of reassessment. Reassessment is extremely costly; estimates range from $15 to $25 million or more. Current state law mandating a "rollback" tax rate makes reassessment a revenue-neutral proposition in its first year. The general rule of thumb is therefore that one-third of property taxpayers will see increases, one-third will see no change, and one-third will see decreases. On a longer-term basis, if assessments are updated on a regular and/or rolling basis, there is an opportunity for revenue gains in an era of rising property values. However, the regular updating of assessments presents a downside risk when property values decline, as they did during the Great Recession. Under the current policy, the County may be foregoing additional revenue when times are good, but the trough of a recession will be (and has been) shallower during slack times. Reassessment presents an additional opportunity for negotiation with the State (see discussion under Opportunities, below).

Opportunities

It is said that inside every difficulty lies an opportunity. In that spirit, the Transition Team notes the following opportunities, which we divide into three categories of recommendations: general, revenue, and expenditure.

General Recommendations

1. Our most important recommendations concern future interactions with the State. We recommend active engagement with the other two Delaware counties, as well as municipalities and school districts, to negotiate on revenue/spending issues with the State's administration and General Assembly.

We further recommend a posture of negotiation, rather than simply resistance, regarding such issues. Statewide property tax proposals (see further discussion under Threats, below) provide an additional opportunity for negotiation, given that it is the counties that collect the tax. Further, State threats to revenue streams, and possible unfunded mandates, provide an opportunity for pursuing true Home Rule. The Transition Team recommends that strong consideration be given to any bargain that would give the County true autonomy in the revenue collection area, even if in exchange the County had to absorb additional costs.

2. On a more mundane level, due to the multiplicity of revenue-related legal issues, we recommend the dedication of an Assistant County Attorney with experience in banking and finance law to the Finance Department.

3. As mentioned previously, the Sewer Fund is burdened with very heavy fixed costs, making it unlikely that efficiencies by themselves will yield a solution to its structural deficit. Our recommendations for the Sewer Fund therefore focus mainly on fairness to users by revamping the rate system. As a start, given those high fixed costs, we recommend that sewer rates be redesigned to include a fixed cost component rather than just usage.

4. We also recommend that consideration be given to the adoption of a stormwater utility. Currently, all property owners contribute to stormwater runoff and benefit from stormwater improvements, but only owners hooked up to the wastewater system pay for such improvements. Removing the cost of stormwater improvements from the Sewer Fund would not by itself balance the Fund, but it would help.

5. We also recommend that consideration be given to changing sewer bills from annual to quarterly (as are those of Sussex County), particularly if rates rise. We recognize that this recommendation may be slightly more expensive than annual billing.

Revenue Recommendations

1. The Transition Team believes that the single best opportunity for the new administration is to thoroughly review the Assessment Office. A complete review could produce both revenue and efficiencies. Despite its importance to the County's revenue base, the Assessment Office has not received the proper focus, and has been frequently relocated on the organization chart. It has been undervalued, and needs direction and emphasis. Discretion at the staff level appears disproportionate. There is a backlog of assessment appeals, directed to

an Appeals Board that is apparently overly persuaded by emotional pleas. It should also be noted that while a property owner can appeal adverse decisions of Assessment Appeals Board to Superior Court, the County cannot. As a starting point, we recommend a review of the 2011 Public Financial Management study of the Assessment Office.

2. Although fees and charges in sum make up a minor portion of the County's revenue, they nevertheless should be reviewed from top to bottom to insure that, at a minimum, they have kept up with inflation.

3. As previous administrations, consultants, and transition teams have done, we note that the grandfathered senior citizen sewer billing discount is out of proportion to the need for such a discount, and should be reviewed and modified downward.

4. In a similar vein, we wish to be the latest body to state that the first-time homebuyer exemption from the realty transfer tax appears overly generous for high dollar properties. Unfortunately, this exemption is set at the state level.

5. We recommend making every effort to obtain the Social Security numbers of delinquent taxpayers and add them into the County's existing database. This will allow for the County's full participation in the State income tax refund intercept program.

6. With the economy in recovery (albeit an uneven one), we recommend reexamination of the "no Sheriff's sale due to unpaid back taxes or sewer service fees" policy.

7. We also recommend reexamining the legality of taxing all betterments (improvements), given that Kent County is already doing so via an expanded definition of such betterments.

8. We recommend consideration of a public safety fee as a revenue enhancement.

9. Currently, the State makes PILOT (payment in lieu of taxes) contributions to the municipalities of Wilmington, Dover, and Georgetown. In the context of overall negotiations, the County should consider requesting a modest PILOT payment from the state, given that New Castle County has considerable non-taxed state property within its borders. We also recommend that the County consider negotiating appropriate PILOTs with non-profit organizations or, alternatively, developing fees to recoup some of the cost of public services enjoyed by those non-profits (such as the aforementioned public safety fee, as all

non-profits benefit from County public safety functions).

10. Finally, should revenue measures become necessary, we recommend that the administration consider carefully not just one year's budget, but rather, the full four years of the Executive's term. One larger tax increase may well be preferable to multiple smaller tax increases, especially if they generate the same amount of revenue. We also note that historically, revenue increases are more easily obtainable in odd numbered years, given that half of County Council is up for election each even numbered year.

Expenditure Recommendations

1. We recommend a one-time, special audit of County finances. The well-publicized and apparently unilateral investment changes made by the former Chief Administrative Officer suggest that such a review is advisable. With the start of a new administration, a fresh set of eyes may be very useful. We emphasize that such an audit should not be construed as a negative judgment on current employees of the Finance Department. Even if the audit determines that all is in order, that conclusion in and of itself would be valuable information.

2. We recommend continued exploration of opportunities to reduce costs via shared services with other local governments, in addition to the previously initiated discussions with the City of Wilmington.

3. We recommend a review of all consulting contracts executed by the previous administration with a value of less than $50,000. We recommend this step because these contracts were not reviewed by Council.

4. The County's General Fund, like that of many governments, primarily pays for personnel. As a result, any serious cost control will of necessity focus on employee costs. We therefore recommend a careful review of all 100+ vacant County positions (some of which are Sewer Fund). We do not recommend a blanket hiring freeze, but we do recommend a careful review of all hiring. Any positions that are vacant or become vacant should not be filled until they have been carefully scrutinized.

5. We also recommend a review of the FY 2017 98.5% funded salary figure, which seems somewhat high given that 6.3% of all positions are currently vacant (recognizing that severance payments, per longstanding practice, are not budgeted).

6. Workers compensation costs have continued to rise, year after year, at a rate much higher than the rate of inflation. We recommend a thorough review of

this area as there may be an opportunity to control costs.

7. The Transition Team had neither the opportunity nor the time to conduct a line-by-line review of the County's operating budgets. We strongly recommend that the Administration due so in advance of its initial budget presentation. We make this recommendation because 1) there is almost no such thing as a government budget that does not contain some opportunity to reduce costs, and 2) if revenue measures do become necessary, it is important that the County Executive be able to tell the public that his administration has taken a fine-tooth comb approach to every dollar of county spending, and only then has it recommended increased revenue.

Threats

Finally, the Transition Team is aware of the following threats.

1. By far the greatest threat to the County's finances is changes that might be made by the State given its own financial difficulties. Previous state proposals have already been revived that would reduce the state's share of paramedic funding, claim a greater share of RTT revenue, take control of County row offices, and/or shift not just funding for, but actual administration of, animal control to the counties. All, obviously, would negatively impact the County. Even more problematic is the possibility that the State would enact a statewide property tax. A proposal for a statewide property tax to fund Delaware Technical and Community College infrastructure has previously been introduced, and proposals for such a tax to aid the State's general fund and/or assist the fire service are under discussion. Enactment of any such statewide tax would make the County's ability to increase property taxes for its own use that much more politically difficult. Again, we emphasize 1) the necessity of engaging and negotiating rather than simply resisting all possible changes, and 2) the importance of establishing partnerships with the other counties, municipalities, and school districts for the purpose of negotiating.

2. Given the stated philosophy of current Congressional majorities in both houses of Congress, and of the President's nominee for OMB Director, it is highly unlikely that the amount of federal funding available to the County will remain stable. A decrease is much more likely. The County currently receives roughly $20 million in federal funding, of which approximately $16 million goes for Section 8 housing. In addition to decreased service delivery, federal funding

reductions jeopardize the jobs of the 30+ County employees funded via such grants. These positions are mostly unionized, which means that their contracts give them bumping rights in the event of any layoffs. Bumping, when it occurs, generates an administrative nightmare.

3. The expiration of COPS grant funding for 15 police officers in FY 2019 will necessitate a large and recurring expenditure of new general funds (ca. $2.25 million annually).

4. The closing or downsizing of major businesses (e.g., Astra Zeneca) represents a considerable risk to the County's revenue base.

5. Liberal annexation laws governing all incorporated municipalities except Wilmington place the County's property tax base at similar risk. While the Team is not aware of current annexation proposals, considerable annexation has already taken place and, obviously, it is a one-way process.

6. Finally, forthcoming GASB recommendations this year and in 2018 are likely to impact pension and OPEB funding calculations in a way that increases required contributions. Pension and OPEB pressures can therefore be expected to get worse before they get better.

List of Abbreviations

ARC	Annual Required Contribution
CABS	Comprehensive Annual Budget Summary
CAFR	Comprehensive Annual Financial Report
CIP	Capital Improvement Program
COPS	Community Oriented Policing Services
FOP	Fraternal Order of Police
FY	Fiscal Year
GASB	Government Accounting Standards Board
NCCFAC	New Castle County Financial Advisory Committee
OMB	Office of Management and Budget
OPEB	Other Post-Employment Benefits
PILOT	Payment In Lieu of Taxes
RTT	Realty Transfer Tax